How Credit Could Counter the Impact of Rising Rates

Historically, lower-rated securities have outperformed U.S. Treasury bonds and core bonds during periods of rising Treasury yields.

Featured Contributor

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Figure 1. Credit Has Performed Well During Periods of Rising Yields

Returns during recent periods of greater than 100 basis points rise in the 10-year U.S. Treasury yield

Period	10-Year U.S. Treasury[1]	Bloomberg Barclays Aggregate[2]	Short-Term Corporates[3]	Floating Rate Loans[4]	High Yield Bonds[5]	Convertible Bonds[6]	S&P 500[7]
09/30/1993 – 11/30/1994	-8.9%	-3.0%	2.1%	11.3%	1.2%	-2.7%	1.8%
01/31/1996 – 08/31/1996	-6.0%	-1.8%	1.7%	4.8%	3.1%	5.4%	3.9%
09/30/1998 – 01/31/2000	-7.7%	-0.6%	4.2%	4.9%	3.7%	41.4%	28.3%
06/30/2005 – 06/30/2006	-5.8%	-0.8%	2.3%	6.7%	4.7%	9.4%	8.6%
12/31/2008 – 12/31/2009	-9.9%	5.9%	21.3%	44.9%	57.5%	49.1%	26.5%
08/31/2010 – 03/31/2011	-6.1%	-0.8%	2.3%	7.4%	10.3%	19.2%	27.8%
07/31/2012 – 12/31/2013	-6.2%	-1.1%	3.2%	7.0%	9.5%	22.9%	25.7%
06/30/2016 – 12/31/2016	-7.5%	-2.5%	0.6%	5.4%	7.5%	8.3%	8.1%
8/31/2017 – 10/31/2018	-5.3%	-2.1%	0.9%	5.1%	1.9%	5.8%	10.3%
7/31/2020 – 02/28/2021	-7.5%	-2.3%	1.7%	8.0%	7.2%	35.0%	17.6%
Average	**-7.1%**	**-0.9%**	**4.0%**	**10.6%**	**10.7%**	**19.4%**	**15.9%**

[1]FTSE 10 Year Treasury Bond Index. [2]Bloomberg Barclays U.S. Aggregate Bond Index. [3]ICE BofA U.S. Corporate BBB-Rated 1-3 Year Index. [4]Credit Suisse Leveraged Loan Index. [5]ICE BofA U.S. High Yield Constrained Index. [6]ICE BofA Convertibles Index. [7]S&P 500 Index.

Source: Morningstar. Data compiled March 10, 2021. Returns for periods of greater than one year have been annualized. One basis point equals one one-hundredth of a percentage point.

Performance data quoted reflect past performance and are no guarantee of future results. Performance during other time periods may have been different or negative. Other indexes may not have performed in the same manner under similar conditions. Source: Morningstar. For illustrative purposes only. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Credit Could Counter

Markets have been paying close attention to the recent move in U.S. Treasury yields. With accommodative monetary policy from the U.S. Federal Reserve (Fed), hopes of a re-opening economy driven by positive vaccine developments, and a new round of fiscal stimulus coming, the yield on the benchmark 10-year U.S. Treasury note jumped about 50 basis points (bps) between early February and early March 2021. This has led to some market volatility as investors try to decipher how a potential uptick in inflation and higher rates might affect markets.

Rising Treasury yields are generally considered a negative for bonds, so a common question from fixed income investors has been "how will my portfolio perform during a period of rising rates?" To help address this question in the past, we have summarized the performance of various fixed income sectors during previous episodes of a rise of more than 100 bps on the 10-year Treasury note. Since the 10-year yield has risen by over 100 basis points from a low of 0.51% in August 2020, we have updated the data in Figure 1 on the first page.

Return Differentials

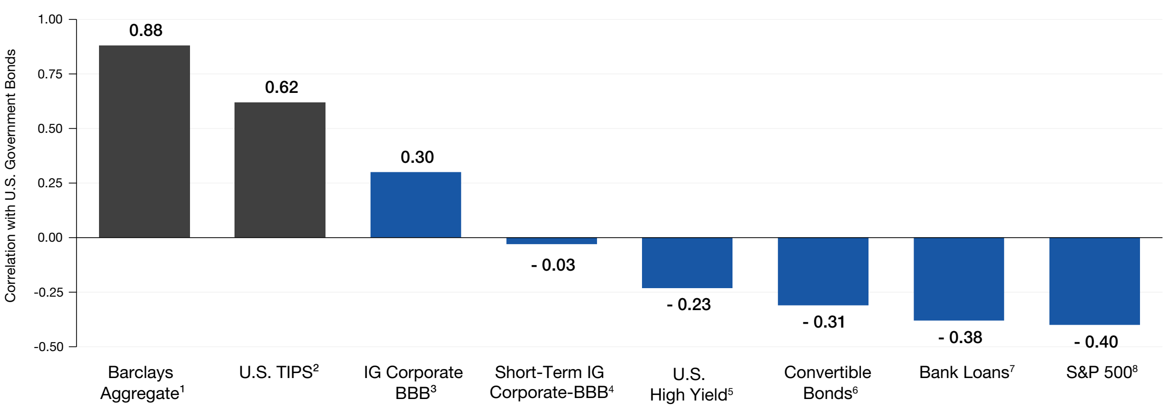
The patterns of returns over the past six months resemble the return profiles of various credit sectors in previous episodes. As simple bond arithmetic would suggest, rising Treasury yields translate to lower bond prices. The most recent period was no different: during the past six months, the 10-year Treasury note suffered a loss of 7.5%, not unlike the losses suffered in the previous nine periods. The Bloomberg Barclays U.S. Aggregate Bond Index, a common proxy for intermediate-term core bond portfolios with a large exposure to U.S. Treasury and government-related securities, generated a loss of 2.3%. We noted in the January 11 *Market View* that the index started 2021 with a 1.1% yield and a 6.2-year effective duration, leaving little cushion to protect investors from rising rates.

Moving across the table to lower-duration and lower-rated credit, you see positive returns in short-term corporate bonds, high-yield bonds, and floating-rate bank loans in all 10 periods. While there has been a lot of focus on how rising rates may affect equities, nearly all of the rising-rate periods in the table were positive for equity-related securities (convertible bonds had one negative showing in 1993-94).

Why the large dispersion in returns in fixed income? Periods of rising Treasury yields are often accompanied by improving economic growth prospects, potentially leading to a rise in corporate earnings, better credit fundamentals, and increasing investor appetite for risk. This generally leads to credit spread compression to help offset the rise in Treasury rates. These credit-sensitive segments tend to exhibit negative correlation with U.S. Treasuries (see Figure 2) and deliver positive returns when yields are on the rise, and the current episode has been no exception.

Figure 2. Credit Sectors Have Diversified Core Bond Allocations

Correlation with Bloomberg Barclays U.S. Government Bond Index, January 1, 2010–December 31, 2020



[1]Bloomberg Barclays U.S. Aggregate Bond Index. [2]Bloomberg Barclays U.S. Treasury U.S. TIPS Index. [3]Bloomberg Barclays U.S. Corporate Baa-Rated Index. [4]ICE BofA U.S. Corporate BBB-Rated 1-3 Year Index. [5]Bloomberg Barclays U.S. High Yield Index. [6]ICE BofA All Convertibles All Qualities Index. [7]Credit Suisse Leveraged Loan Index. [8]S&P 500 Index.

Source: Morningstar. **Past performance is not a reliable indicator or guarantee of future results**. Correlation is a statistic that measures the degree of association between two variables. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

The recent rise in rates, in part, reflects investor confidence that economic growth will improve as the economy emerges from the COVID-19 crisis. While longer-duration government-related securities are the most sensitive to rate moves, lower-duration credit sectors have less exposure to duration, provide additional carry over Treasuries, and have benefited from credit spread compression during this period.

Other Considerations

It may be too simple to say, "rates are rising." Other factors to consider include:

- Which rates are going up, and how fast are they moving?
- What was the starting point of the rise?
- Are they going up due to improving growth prospects or inflation fears?
- Will the Fed have to take aggressive action to stop inflation from overheating?

Each period of rising rates needs to be analyzed in the context of the broader market environment. A rapid rise in inflation fears or concerns that the Fed will need to take aggressive action would lead to a high degree of uncertainty, and thus likely be a negative for risk assets. But the history depicted in Figure 1 would suggest that periods of rising Treasury yields—particularly if they are rising due to improving prospects for economic growth—can be a positive for equities and credit-related assets.

Summing Up

Over the years, forecasters have had little success in consistently predicting the direction of interest rates. However, taking history as a guide, if we continue to see a move to higher U.S. Treasury yields, short duration bonds, high yield bonds and floating rate loans would likely outperform core bonds. Investors may be well served by looking to add exposures to these credit sectors to diversify the duration exposure of core bonds. Alternatively, instead of buying the individual components, one may wish to consider a multi-sector strategy that is diversified across investment grade and high yield credit, giving the manager flexibility to position the portfolio most appropriately for the given economic environment.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results. Statements concerning financial market trends are based on current market conditions, which will fluctuate.

This *Market View* may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements.

TIPS (Treasury inflation-protected securities) are U.S. Treasury securities indexed to inflation in order to protect investors from the negative effects of inflation. The principal of a TIP is adjusted according to the CPI-U. With a rise in the index, or inflation, the principal increases. With a fall in the index, or deflation, the principal decreases. Though the rate is fixed and paid semi-annually, interest payments vary because the rate is applied to the adjusted principal. Specifically, the amount of each interest payment is determined by multiplying the adjusted principal by one-half the interest rate. Upon maturity, TIPS pay the original or adjusted principal amount, whichever is greater. Because TIPS are adjusted for inflation, a change in real interest rates (but not nominal interest rates) will affect the value of TIPS. When real interest rates rise, the value of TIPS will decline, and when real interest rates fall, the value of TIPS will rise.

A **basis point** is one one-hundredth of a percentage point.

A **bond yield** is the amount of return an investor will realize on a bond. Though several types of bond yields can be calculated, nominal yield is the most common. This is calculated by dividing the amount of interest paid by the face value.

Carry represents the additional return accruing to an investor from holding a higher yielding security over a lower yielding security, assuming prices remain constant.

Duration is the change in the value of a fixed-income security that will result from a 1% change in market interest rates. Generally, the larger a portfolio's duration, the greater the interest-rate risk or reward for underlying bond prices.

The **Bloomberg Barclays Corporates Baa Index** is the Baa component of the Bloomberg Barclays U.S. Corporate Investment Grade Index. The index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The Index covers the U.S. investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** is a market value-weighted index which covers the U.S. non-investment grade fixed-rate debt market. The index is composed of U.S. dollar-denominated corporate debt in Industrial, Utility, and Finance sectors with a minimum $150 million par amount outstanding and a maturity greater than one year. The index includes reinvestment of income.

The **Bloomberg Barclays U.S. Floating Rate Note Index** is designed to measure the performance of U.S. dollar-denominated, investment grade floating rate notes.

The **Bloomberg Barclays U.S. Government Bond Index** is a market value-weighted index composed of all publicly issued, nonconvertible, domestic debt of the U.S. government or any agency thereof, quasi-federal corporations, or corporate debt guaranteed by the U.S. government. Flower bonds and pass-through issues are excluded. Total return consists of price appreciation/depreciation plus income as a percentage of the original investment. Indexes are rebalanced monthly by market capitalization.

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The **FTSE 10 Year U.S. Treasury 10 Year Bond Inde**x is designed to measure the performance of U.S. Treasury securities with a maturity of 10 years.

The **ICE BofA All Convertibles, All Qualities Index** contains issues that have a greater than $50 million aggregate market value. The issues are U.S. dollar-denominated, sold into the U.S. market and publicly traded in the United States.

The **ICE BofA U.S. High Yield Master II Constrained Index** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $100 million.

The **ICE BofA U.S. Corporate BBB-Rated 1-3 Year Index** is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with between one and three year remaining to final maturity.

The **ICE BofA U.S. Convertible Index** tracks the performance of publicly issued U.S. dollar-denominated convertible securities of U.S. companies. Qualifying securities must have at least $50 million face amount outstanding and at least one month remaining to the final conversion date.

ICE BofA Index Information:
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